CHASE

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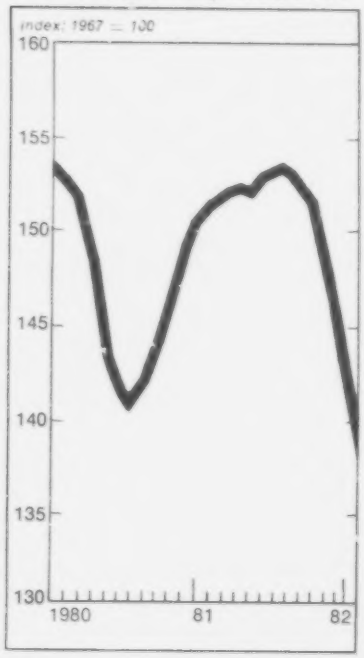
## A Spring Recovery For the United States?

The U.S. recession is more than seven months old—already longer than the 1980 recession, but still several months under the average length of economic contractions since World War II. Statistical indications of future developments are mixed, as they generally are at this stage of a cycle. Nevertheless, there is an emerging consensus among economists that the cyclical low point will fall within the March-May period. There is much less agreement, however, on how vigorous or how long-lived the ensuing expansion will be.

Perhaps the most encouraging development has been the speed and vigor with which business has moved to get its inventories back into balance with the lower level of sales. The immediate effects of such a response are of course negative—a sharp decline in production (see chart), and a further cutback in employment and income. However, although these developments may be painful, they are a necessary part of the process that ultimately brings recessions to an end. Inventories were reduced, in real terms, in December, and cutbacks apparently have continued since then. In the past, the cyclical low point in the economy has generally been reached within a very few months after inventories began to decline. Other favorable signs include a modest downtrend in interest rates, and further abatement in the rate of price inflation. The Consumer Price Index has risen at an average annual rate of under 5% since last October. In the third quarter of last year the rate was over 12%.

U.S. industrial production




An economic upturn beginning in the spring months would probably be slow at first. But fiscal policy will provide a boost in July, when a cut in personal income taxes and a rise in Social Security retirement payments will add about $45 billion (or 2%) to incomes after taxes. That should speed up the pace of recovery. Alternatively, if the pessimists are correct and the recession continues until summer, the fiscal stimulus should help bring it to an end.

Even with an early upturn, U.S. economic growth will be modest this year—perhaps 1-1½%, year-end to year-end. And there is widespread concern that performance in 1983 might not be much better. The administration's projection for 1983 growth is 5.2%, which is four or five times the estimated growth for the previous three years combined. In private circles, there are fears that growth in 1983 may again be severely constrained by another rebound in interest rates, reflecting the combination of restrictive monetary policies and federal deficits that may remain stubbornly over $100 billion a year.

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*German domestic economy remains depressed; recovery hopes hinge on export performance.*

Despite relatively strong export growth, Germany's domestic economy is continuing to weaken. Seasonally adjusted real GNP fell at an annualized rate of some 0.7% in the fourth quarter, even though export volume rose at an annual rate of 12%. The decline in real domestic demand was led by fixed investment, which fell 13%. The volume of domestic industrial orders was down 8% in the final quarter of 1981, and recent numbers fail to show an upturn. This poor performance, together with the continuing high level of real interest rates, is leading economists to revise down their growth forecasts for 1982—despite a provisional report that showed industrial production rose in January. Domestic demand now seems likely, at best, to remain flat, at worst, to decline by some 2%. The hope of positive real growth this year hinges on export performance, which should remain strong through the first half of 1982, but, in the absence of an early recovery in the rest of Europe, looks increasingly vulnerable in the second half of the year.

*Devaluation first step in Belgian recovery program, real wage cuts must come next.*

Following last month's loosening of wage indexation, the Belgian authorities devalued the central rate of the Belgian franc against the German mark by 8.5%. The devaluation was accompanied by a one-month price freeze, cuts in electricity and gas tariffs to reduce industrial costs, and additional investment incentives. This package, together with earlier measures to shrink Belgium's large public sector deficit, has allowed the franc to remain within its new band against other currencies in the European Monetary System, thus giving the authorities room to reduce interest rates. The ultimate success of the devaluation, however, depends on the authorities' ability to reduce real wages. Although the 3% cut currently envisaged should help to improve export competitiveness, it will not be sufficient to overcome the competitive disadvantage suffered by Belgian exports since the mid 1970s.

*Inflation and balance-of-payments problems continue to plague Portuguese economy.*

Portugal's crippling drought of 1981 has finally ended. However, the resurgence of domestic labor unrest serves as a reminder to the authorities of the economic problems they still face. Consumer price inflation now stands at a year-on-year level of 23.7% after an acceleration in the second half of 1981. This, together with a tight 1982 budget, has put a squeeze on real wages and consumer spending. Meanwhile, the balance-of-payments performance offers only minimal relief. In the first three quarters of 1981, the current-account deficit was $1.87 billion, more than double the deficit over the same period for 1980. Depressed EEC markets offer only limited opportunities for an early export recovery, despite the December increase in the monthly crawling peg devaluation rate. However, the soft oil market and the expectation of a "normal" year of rainfall should be sufficient to reduce the 1982 current-account deficit to below $2 billion.

*Caribbean Basin aid/trade programs could set stage for economic revitalization.*

President Reagan's Caribbean Basin Initiative announced last month could help lay the groundwork for revitalizing a region beset with political and economic problems. The U.S. president's plan, unveiled at the February meeting of the Organization of American States, includes a series of interrelated trade, investment, tax, credit, and financial assistance measures designed to stimulate economic development for nearly two dozen countries in Central America, northern South America, and the Caribbean. Complementary programs have been put forth by Canada, Mexico, and Venezuela. A key component of the U.S. initiative is a 12-year "free-trade" arrangement, whereby imports from the Caribbean Basin to the United States would be duty free. (Exceptions would be made for imports of certain textile and apparel products which are controlled by the international Multifiber Agreement.) The hope is that the lifting of import duties, combined with other proposed investment tax incentives and increased guarantees for trade credits to the region, will spur private sector investment.

Mr. Reagan has also proposed increasing direct U.S. economic assistance to the Caribbean Basin countries to a total of $824 million for fiscal 1982. The results of the aid plan are likely to be neither quick nor dramatic over the near term. Much of the program requires approval of the U.S. Congress. And the recipient countries must be prepared to respond to the initiatives. Nevertheless, a beginning has been made, and if approved and implemented vigorously it could represent a positive opportunity for the Caribbean Basin countries to achieve sustained economic progress over the long run.

*Colombian authorities adopt new credit measures to stimulate economy.*

The Colombian government has taken a series of monetary measures to stimulate the economy after last year's slow growth. Real GDP advanced by only 3%-3.5% in 1981 and business complained about high domestic interest rates. The recent policy adjustments are designed to add additional liquidity in the economy and ease the pressures on interest rates. One of the most critical of the new monetary steps taken is the central bank's "unfreezing" of 5.5 billion pesos for specific use in agricultural, industrial, and electrical projects. Equally important, the authorities have reduced prior import deposits for raw materials and consumer goods to 20% from 35% and eliminated the deposit on capital goods. Internationally, the authorization for foreign loans has been liberalized by increasing the number of eligible borrowers. Previously, such loans had been limited to a few lines of activity. Although some concerns have been expressed that monetary stimulation might push up last year's 28% inflation rate, careful economic management should permit some increase in economic growth without excessive price pressures.

*Recovery likely to be slow for weak Australian dollar.*

The Australian dollar's recent weakness reflects not only the strength of the U.S. dollar against other major currencies, but also the deterioration of Australia's balance of payments over the last year. Continued labor disputes and the uncertainties regarding the long-term demand outlook, dampened last year's resource boom considerably. Foreign investment inflows, as a result, slowed from $4.1 billion in the first half of 1981 to only $3.1 billion in the second half, and the current-account deficit widened to $4.4 billion from $3 billion. There was, however, one positive effect. The resulting deficit in the overall balance of payments—by soaking up domestic liquidity—actually helped maintain tight monetary control, which, in turn, kept potential wage pressures in check. At the moment, farmers and exporters are demanding further devaluation, but the government is resisting such action for fear of fueling inflation. The Australian dollar by now may have just about hit bottom. Its recovery, however, is likely to be slow, depending on the course of the world economy and U.S. interest rates.

*Sri Lanka maintaining tight rein on government budget.*

The government of Sri Lanka last year showed considerable improvement over 1980 in keeping its budget in line. The overall budget deficit is estimated to have been 12.5 billion rupees—actually slightly less than the revised budget target of Rs. 12.7 billion. And bank borrowing for deficit financing is estimated to have been contained at Rs. 3.8 billion, relatively close to the figure budgeted and down sharply from 1980's Rs. 7.2 billion. The 1982 budget calls for a sharp increase in capital expenditures as the Mahaweli-Ganga Development Project picks up steam. To hold the budget deficit to Rs. 18.4 billion, new tax initiatives have been undertaken. With a sharp increase in foreign aid, much of which has already been committed, bank borrowing for deficit financing is to be held at Rs. 2.97 billion or an estimated 2% of GDP. The budget clearly is tight. Actual aid disbursements could easily fall short of projections. Moreover, the government must also act to pass along increases in international prices in order to hold down subsidies and costs. Still, the 1982 budget seems to be one of the more responsible budgets prepared by the government in recent years.

# Market Yield Spreads Widening

Over the past few weeks, the fixed-income securities markets have witnessed a significant widening of yield spreads between instruments of the same maturity, not only between corporate and government securities, but between different kinds of corporate bonds, as well. Among instruments of three-month maturities, for example, the spread between prime commercial paper and Treasury bills has risen to 135 basis points—substantially higher than the 80-basis-point spread averaged over the 1970s. Moreover, in the longer-term markets, A-rated corporate industrial bonds currently yield over a full percentage point higher than AAA bonds of the same maturity, which, in turn, are about 80 basis points higher than comparable Treasury bonds. These spreads compare with average yield differentials of only 50 and 25 basis points, respectively for the 1970s.

Yield differentials generally exist for a variety of reasons. Differences in the default risk associated with the issuers of the instruments are a major determinant, although the market supply-demand conditions for individual securities also play an important role. For instance, the financing needs of a particular issuer or investor perceptions of the problems in a specific industry can cause wider yield spreads between securities of similar default risk. In addition, different characteristics of the securities, such as call features and size of coupon payments, also affect yield spreads.

For the most part, the current spreads reflect investors' concerns about the state of the economy and the financial difficulties of the issuers. Typically, as the trough of a recession approaches, the default risk associated with corporate debt instruments rises as profits decline and some over-leveraged firms experience trouble in covering their interest payments. On average, this increased risk manifests itself in higher interest rates on corporate instruments (commercial paper and bonds) relative to default-free government obligations of comparable maturity.

Similarly, the spreads among corporate bonds of different quality ratings widen during recessionary periods. Although lower-rated bonds always carry higher yields than higher-rated bonds, the significance of the rating difference grows as the market perceives a greater risk of default in the poorer-performing firms.

Despite these recent developments in yield structures, however, it is useful to compare the current spreads to their magnitudes in 1981. Although spreads are currently wider than they were a month ago, they were significantly wider still during last year. There are two possible explanations for this: Corporate securities may have lower yields relative to Treasury debt, because the adverse impact of the recession on

## Africa and Middle East Bimonthly Survey of Business and Finance

| | COUNTRIES | CURRENT BUSINESS CONDITIONS | EXPORTS | | GNP IN 1980 | | BALANCE | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | 6 months ending | change from year earlier | in billions of dollars | per capita | latest data | reserves (less gold) in million $ | 12-month change | months of imports covered | u cr lion |
| Africa | Algeria | French companies awarded several project contracts following agreement on gas prices. | Nov. | −21% | 36.0 | 1,935 | Jan. | 3,590 | − 2% | 4.5 | |
| | Cameroon | Fuel and pulpwood production to be expanded with aid of $17-million World Bank loan. | Mar. '81 | + 6% | 6.5 | 790 | Sept. | 95 | − 52% | 0.5 | |
| | Egypt | Foreign direct investment in petroleum sector rising; several new oil finds announced. | Sept. | + 4% | 22.7 | 535 | Nov. | 1,230 | + 16% | 1.7 | |
| | Gabon | National budget for 1982 curbs spending, emphasizes productive investment. | Dec. '81 | 0 | 3.6 | 6,545 | Sept. | 194 | +123% | 1.3 | |
| | Guinea-Conakry | U.S. Steel Company to take key role in developing Mifergui-Nimba iron ore project. | Dec. '80 | +11% | 1.5 | 270 | n. a. | — | — | — | |
| | Liberia | Economy stagnates; only agriculture shows modest growth. | Nov. | −11% | 1.1 | 570 | Nov. | 8 | − 11% | 0.2 | |
| | Libya | Development outlays to be cut 5% in 1982 owing to drop in oil revenues. | Nov. | −50% | 23.0 | 8,050 | Dec. | 9,003 | − 31% | 8.6 | |
| | Morocco | Foreign investors to be allowed full ownership of local companies. | Sept. | + 1% | 18.1 | 896 | Dec. | 230 | − 42% | 0.6 | |
| | Nigeria | Economic growth continues somewhat dampened owing to lower oil output. | Nov. | −42% | 78.0 | 1,013 | Dec. | 3,894 | − 62% | 2.5 | |
| | Senegal | Dakar free industrial zone gained seven new plants in 1981, creating 900 new jobs. | Dec. | − 9% | 2.5 | 437 | Nov. | 6 | − 52% | 0.1 | |
| | South Africa | General sales tax raised to 5% from 4% as budget deficit widens. | Dec. | −26% | 76.7 | 2,618 | Jan. | 588 | − 37% | 0.3 | |
| | Tanzania | Shortages of parts and materials reduce manufacturing sector output to 30% of capacity. | June | + 5% | 6.0 | 325 | Nov. | 23 | − 53% | 0.2 | |
| | Tunisia | Government spending on development projects rising. | Oct. | +13% | 8.6 | 1,350 | Jan. | 596 | + 13% | 1.9 | |
| | Zimbabwe | Severe drought may halve maize harvest; cotton, tobacco, wheat, and livestock also affected. | Dec. | − 5% | 4.8 | 645 | Aug. | 220 | − 30% | 1.7 | |
| Middle East | Kuwait | Major contract awards for new development projects totalled $3.6 billion in 1981. | Nov. | −15% | 27.3 | 19,870 | Jan. | 4,023* | 0 | 7.3 | |
| | Qatar | Gas production shortfalls delay plans to increase domestic petrochemical output. | Nov. | −15% | 5.0 | 23,100 | Sept. | 347* | − 10% | 3.5 | |
| | Saudi Arabia | Pace of development outlays continues strong. | Nov. | + 9% | 117.6 | 14,050 | Jan. | 32,675* | + 30% | 12.6 | |
| | United Arab Emirates | Federal expenditures rising with development of power projects. | Nov. | − 4% | 19.4 | 23,000 | Jan. | 3,104* | + 29% | 4.4 | |

*Excluding state reserves.

corporate profits, in the market's estimation, may be less severe than was expected during 1981. An alternative explanation, however, is that Treasury yields have risen relative to corporate yields, because of investor uncertainty about the federal deficit. The large supply of government debt expected to be brought to market could be putting upward pressure on Treasury yields, keeping the corporate-government spread narrow relative to last year's experience.

Not all wider yield spreads are reflections of a general deterioration in economic activity, however. Yield differentials between debt instruments of issuers in different industries may be influenced by the particular circumstances of those industries. For example, the yield on AAA utility bonds is currently a relatively large 125 basis points higher than the yield on similar industrial bonds. This premium on utility bonds is probably due to investor uncertainty over the outlook for electric and communication utilities. Prospects for future energy costs and the feasibility of nuclear power plant construction, as well as the future organization of the telephone industry, are sources of concern which manifest themselves as industry risk premiums.

Other yield spreads arise from differences in the characteristics of the bonds. Two of the most important of these are the size of coupon payments and call provisions. The size of coupon payments is always a significant determinant of yield spreads, and higher-coupon bonds usually have higher yields than lower-coupon bonds. For instance, seasoned AAA long-term industrial bonds that carry a 10% coupon currently yield 90 basis points over comparable 7¾% coupon bonds. This premium is related to the differential tax treatment for ordinary interest income and capital gains. Since lower-coupon bonds return a larger proportion of their yield in the form of capital gains, their earnings are taxed at a lower average rate. Because of this advantage, their before-tax yield is generally lower than otherwise-equivalent, higher-coupon bonds.

Even without considering this tax-related issue, however, the size of the coupon payment plays an important role in conjunction with call provisions. Since a call provision enables the corporation to retire the bonds at a specified price prior to maturity, callable bonds always carry a premium over non-callable bonds of similar rating and maturity. This premium increases, however, when market participants anticipate a greater likelihood that the call provision will be exercised—namely, when they expect interest rates to fall. Moreover, the premium is larger for higher-coupon bonds than for lower-coupon bonds, since it is reasonable for corporations to place a priority on retiring their most costly debt obligations earlier. The fact that there now exist examples of callable bonds of equal rating and maturity for which the spread between the higher-coupon and lower-coupon bond has increased also suggests that many investors are anticipating a decline in interest rates.

*Carl Alan Batlin*

| PAYMENTS | | MONEY AND BANKING | | | | | | | COUNTRIES |
|---|---|---|---|---|---|---|---|---|---|
| IMF mil-dollars | current influences on payments | 12-month changes: latest data | consumer prices | latest data | money supply(M1) | exchange rate in U.S. dollars March 10, 1982 | change from year earlier | current monetary conditions | |
| 0 | Oil output in 1981 averaged 808,000 b/d, down 21% from year earlier. | Dec. '79 | +12% | July | +17% | .2270 | − 9% | Foreign exchange reserves held steady through January. | Algeria |
| 4 | Higher oil output points to $800-million surplus on 1981 oil account. | Aug. | + 9% | Sept. | +22% | .00332 | −19% | Credit extremely tight. | Cameroon |
| 8 | Light crude oil price cut $1 for second time since early February. | Sept. | + 7% | Nov. | +15% | 1.21 | −17% | Money supply growing more rapidly. | Egypt |
| 3 | ECGD sets up $10-million credit line at 8.5% to fund British exports to Gabon. | May | + 3% | Sept. | +14% | .00332 | −17% | Credit relatively easy. | Gabon |
| 0 | Low aluminium price dampens 1982 export earnings outlook. | n. a. | — | — | — | .0585 | n. a. | Saudis to back three new financial institutions. | Guinea-Conakry |
| 0 | Exports continue weak owing to sluggish rubber and iron ore demand. | Oct. | +10% | Oct. | −10% | Par | 0 | Credit to private sector contracts. | Liberia |
| 0 | Oil output averaged 1.1 million b/d in 1981, down 39% from year ago. | n. a. | — | Dec.'79 | +33% | 3.4050 | 0 | Expansion of money supply slowing. | Libya |
| 4 | Phosphate production was 22.2 million tons last year, up 6.7% from 1980. | Oct. | +23% | Oct. | + 9% | .1870 | −13% | Local bank (BNDE) raises $52 million Euroloan. | Morocco |
| 0 | Feb. oil output down to 1.45 million b/d, vs. 1.8 million in Dec. and Jan. | June | +24% | July | +32% | 1.5269 | −15% | Value of naira now being adjusted almost daily. | Nigeria |
| 5 | Bumper groundnut crop forecast for 1981/82; cotton also looks good. | Sept. | + 9% | Sept. | − 2% | .00332 | −18% | Liquidity continues very tight. | Senegal |
| 0 | New 10% surcharge affects 40% of all imports. | Dec. | +14% | Nov. | +32% | .9900 | −22% | Short-term foreign borrowings increase sharply. | South Africa |
| 7 | Arrears on import payments estimated at over $270 million. | Jan. '81 | +30% | Mar. | +27% | .1210 | − 1% | Resistance to currency devaluation continues. | Tanzania |
| 0 | Jan.-Oct. 1981 trade deficit was $1.2 billion, up 40% from year earlier. | Oct. | +10% | Nov. | +23% | 1.9180 | −18% | France taking 30% share in new investment bank. | Tunisia |
| 36 | Delivery of locomotives will ease transportation problem. | Dec. | +20% | Dec. | +16% | 1.3870 | −11% | Foreign exchange shortage continues. | Zimbabwe |
| 0 | Oil output down to 600,000 b/d, well below 1.25 million b/d official ceiling. | Dec. | + 8% | Nov. | +51% | 3.5220 | − 3% | Activity increasing in domestic bond market. | Kuwait |
| 0 | Oil output averaged 405,000 b/d last year, down 14% from 1980. | n. a. | — | Sept. | +17% | .2975 | + 8% | Private sector credit expanding more slowly. | Qatar |
| 0 | Aramco output now at 7-7.5 million b/d, vs. 9.6 million average in 1980-81. | June | + 2% | Sept. | +17% | .2930 | − 2% | Money supply growth accelerates. | Saudi Arabia |
| 0 | Abu Dhabi's 1981 oil output averaged 1.13 million b/d, 16% below 1980. | n. a. | — | Nov. | +25% | .2730 | 0 | Credit to private sector rising steadily. | United Arab Emirates |

# World Interest Rates

*market rates of March 10, 1982; bond yields as of March 5, 1982*

| in percent per annum | U.S. | Canada | Britain | Belgium | France | Germany | Italy | Netherlands | Switzerland | Japan |
|---|---|---|---|---|---|---|---|---|---|---|
| **Central Bank Discount Rate** | 12.00 | 15.12 | 13.5625 intervention rate | 13.00 | 9.50 | 7.50 | 19.00 penalty rate 22.00 | 8.50 | 6.00 | 5.50 |
| **Day-to-Day Money** | 14.50 March 11 | 15.12 | 14.50 | 12.50 | 14.25 | 10.00 | 20.375 | 9.625 | 4.00 | 6.625 |
| **Treasury Bills** 91-day, Middle Rates | 12.45 discount basis | 14.75 | 12.625 | 13.75 | 15.485 | n. a. | 18.25 90-days | no dealing | no market | 5.625 two-month |
| **Commercial Paper** prime, 3-month, asked | 13.50 finance paper discount basis | 15.60 finance paper 15% tax w/h | 12.09 | 12.90 Certified | 14.25 Interbank | no market | no market | no market | no market | not traded |
| **Bankers' Acceptances** 3-month, asked | 13.65 | 15.55 15% tax w/h | 12.5625 | 12.90 Certified | not traded | 9.40 | 22.25 | no market | 6.50 | no market |
| **Government Bonds** Long-term, new and old issues, average yield | 13.40 | 15.50 | 13.58 | 10.7355 20% tax w/h | 16.04 | 9.68 | 20.03 | 10.61 | 5.42 | 7.25 |
| **Industrial Bonds** prime, long-term, new and old issues, average yield | 14.40 Aa Industrials | 17.00 | 14.99 | 15.368 | 17.04 | 9.63 | 20.41 | 11.42 | 6.25 | 7.10 |
| **Bank Short-Term Rate** to Best Borrowers (prime rate) | 16.00 | 16.50 | 14.50 | 17.00 | 15.95 | 13.50 | 21.75 ½ qtrly fee on outstdng. | 11.50 | 8.00 | 6.00 |
| **Bank Time Deposits** 3-month | 13.80 Cert. of Dep. | 15.68 | 13.375 | 13.45 | 14.25 | 9.95 | 10.75 | 9.50 large deposits | 6.00 residents only | 3.75 20% tax w/h |
| **Eurocurrencies** 3-month, asked | 14.7500 | no market | 13.50 | no market | 15.625 | 9.5625 | no market | 9.50 | 6.8125 | no market |
| **Exchange Rates—in U.S.$** rates floating against the $ | — | .8256 | 1.8160 | .0228 | .1658 | .4249 | .000786 | .3859 | .5394 | .00422 |
| **Forward Exchange Cover** 3-month, in percent p.a. *D* = discount, *P* = premium | — | 0.970 *D* | 1.54 *P* | .647 *P* | .970 *P* | 5.391 *P* | 5.612 *D* | 5.391 *P* | 8.052 *P* | 8.381 *P* |

**Eurodollar Deposits**
(London, interbank, bid)
March 11

| | |
|---|---|
| 7-day | 14.75 |
| 1-month | 14.75 |
| 3-month | 14.875 |
| 6-month | 14.875 |

**International Arbitrage**
(3-month, hedged) + *in favor of U.S. dollars*

| | |
|---|---|
| U.S.-U.K. Treasury Bills | −1.541 |
| U.S.-Canada Treasury Bills | − .6238 |
| U.S.-Canada Finance Co. Paper | − .916 |
| Eurodollars-U.K. Local Auth. Deposits | − .1025 |

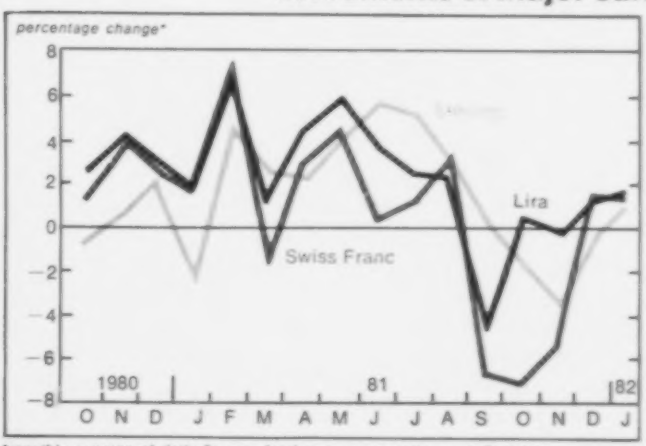
**Eurobonds**
(average yield on recent straight debt issues)

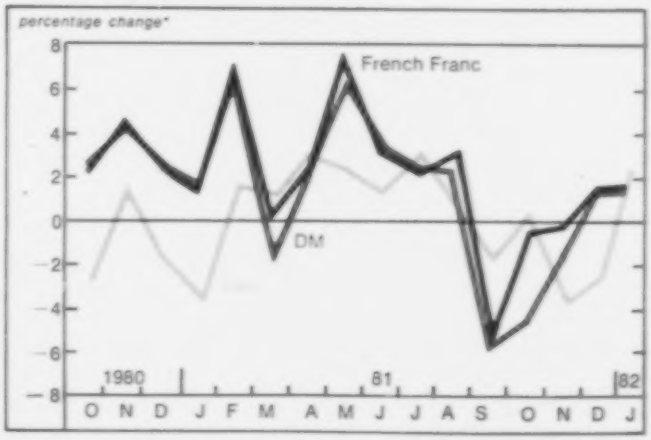
| | |
|---|---|
| U.S. Dollar Bonds | |
| 7 yrs. and under | 14.50 |
| Over 7 yrs. | 14.75 |
| DM Bonds | |
| 7 yrs. and under | 9.85 |
| Over 7 yrs. | 9.80 |

**Gold Price**
London afternoon fixing
333.00
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

## Movements of major currencies against the dollar




*monthly average of daily figures, foreign currency units per U.S. dollar

# Troubles Plague Sudanese Economy

Although optimism still surrounds Sudan's enormous oil potential, a formidable array of problems continues to threaten the country's tottering economy. The largest country in Africa in geographic area, Sudan is unable to feed itself or pay for its food imports. Its infrastructure is grossly inadequate and it is losing desperately needed skilled and semi-skilled workers to higher-paying OPEC nations. Hopes for the virtually bankrupt country's future rest on significantly increased Arab investment—currently not very likely because of the recent decline in oil earnings—and on early exploitation of its petroleum resources.

Standard Oil Co. of California recently estimated that Sudan's probable reserves are as high as 10 billion barrels. If so, that would move Sudan to 14th place in terms of oil deposits, ahead of Indonesia and Algeria. By late 1982, over one-third of Sudan's land area—or 80% of available concession areas—will be under exploration. Sudan's oil is reported to be of excellent quality.

Sudan has a 26,000 b/d refinery at Port Sudan on the Red Sea, and a 25,000 b/d refinery south of Khartoum, at Kosti, is planned. Although slated to come on-stream in 1983 with initial capacity of 15,000 b/d, the Kosti refinery most likely will not be completed until 1986 because of financial problems. No date has been set for oil self-sufficiency and oil exports are not yet contemplated. There would have to be proven reserves of at least a billion barrels before it would be economically justifiable to invest an estimated $3 billion in an export terminal and a pipeline to the coast.

### The payments squeeze

Ironically, spiraling oil bills that swallowed vital foreign exchange helped push Sudan to the economic precipice in the late 1970s. Even more important were overly ambitious development plans aimed at making Sudan the breadbasket of the Middle East and the slow growth of export revenues—owing primarily to lagging earnings from cotton.

The latest IMF-inspired austerity package, adopted by Sudan late last year, seeks to revitalize the economy and win back the international financial community's confidence. The domestically unpopular measures included devaluation of the Sudanese pound, abolition of the two-tier exchange rate system, and discontinuation of subsidies on essential consumer goods, such as gasoline, sugar, wheat, and flour. The program is aimed at decreasing import expenditures, encouraging remittance of expatriates' foreign currency earnings, and providing incentives to agricultural producers.

In particular, Sudan hopes to lure farmers back into cotton production. Although declining in importance, cotton remains its chief export earner, accounting for 36% of total export receipts in 1980/81, down from over 50% in the second half of the 1970s. In 1980/81, a decline in planting, along with pest problems and a lack of rainfall, contributed to a 22% drop in cotton production. Combined with sharply lower world prices, this almost halved Sudan's export receipts. The projected supply-demand picture implies continued price weakening until the world economy improves. In the long run, the main price determinant will be the rising world demand for food and the consequent pressure on cotton acreage.

The decline in cotton plantings, caused mainly by an inappropriate pattern of incentives and crop distribution, has wreaked havoc on Sudan's export performance. Total exports have been stagnating in the $500-600 million range since 1976/77 and fell below $500 million in 1980/81. Since 1975, the value of imports has been more than double that of exports, owing to sharply rising oil prices and development expenditures. The cost of oil imports alone rose from $90 million in 1975/76 to $400 million in 1980/81—a quarter of total imports. The recent foreign exchange moves, coupled with lower sugar imports as domestic production has expanded, should contain overall 1981/82 imports at about the previous year's level. The trade deficit, which reached $1.14 billion in 1980/81, should therefore narrow in 1981/82 if exports return to the level of recent years. However, the negative balance on the services account will deteriorate further as interest payments on the foreign debt rise significantly. Transfers, on the other hand, are expected to record another net positive inflow of around $450 million. This should prevent an increase in the overall current-account deficit, which, after ranging between $400-500 million during 1975-80, has widened to close to $800 million.

Sudan's inability to attract sufficient capital inflows led to payments arrears that reached $1.2 billion by 1979. Reschedulings of foreign debt since then have left these arrears at an estimated $1.0 billion at the end of 1981. Fresh injections of foreign capital will come from a just-approved $224-million IMF loan, another $75 million from commercial banks, and emergency bilateral aid. And this week, Sudan is expected to seek rescheduling of its official debt through the Paris Club.

But real GDP growth, which has been averaging a negative 1% since 1978, is unlikely to turn more than marginally positive in the near term. Inflation, which was still running at 25%-30% last October, is likely to come under further upward pressures from the withdrawal of subsidies and the currency devaluation.

Sudan's problems, however, do not stop at the economic frontier. Uneasy Arab alliances, threats from Libya, and absorption of refugees from Uganda and Ethiopia complicate political uncertainties at home.

*Wally V. Koch*

# Financial Volatility and Policy Choices

For the last several years, the increased volatility in international financial markets has stemmed, in large part, from the erratic growth of the U.S. money supply and its commensurate influence on U.S. interest rates. Given the strong prospects that the U.S.-induced volatility is not likely to subside during 1982, authorities abroad will continue to face critical policy choices concerning how to manage their financial markets in this volatile environment.

Because the world financial markets are linked in a myriad of ways, markets in one country cannot be completely isolated from the shocks received by nor the volatility present in the world system. Policymakers in each country, however, can and do choose to direct the volatility through certain financial channels rather than others. That is, authorities to a large extent have some control over how market disturbances are transmitted to their own economy.

To clarify the policy choices facing authorities abroad in the current environment of widely fluctuating U.S. interest rates, it is useful to distinguish between two mechanisms that transmit financial disturbances: the process of arbitrage—which links domestic financial markets through the foreign exchange market—and fundamental shifts in domestic policy. This distinction is important in that for arbitrage, cause—or the economic event that sets off the process—is unimportant. For disturbances transmitted by policy shifts, however, cause is all important: economic variables are affected worldwide.

The arbitrage mechanism rests on an important principle: interest-rate parity. Interest-rate parity equates the return on a financial investment in one market—say the 90-day Eurodollar rate—with the return on an equivalent foreign-currency investment—say the return on 90-day Euro-German marks, which is covered by a 90-day DM/dollar forward foreign exchange contract. Thus, the differential between the two interest rates equals the forward foreign exchange premium (or discount).

International financial institutions risklessly arbitrage the interest-rate parity relationship. As a result, it is a relationship that is very tight—it always holds. Consequently, the implications for volatility are equally tight. If one part of the equation, say the Eurodollar interest rate, is highly volatile, then either: foreign interest rates are also volatile, or exchange rates are volatile, or both. The critical point, however, is that the source of the volatility is not important. Arbitrage and interest-rate parity are two-way streets.

On the other hand, with fundamental policy shifts, causality is of primary importance. For example, if the current volatility in U.S. interest rates is the result of anti-inflationary U.S. monetary policy, then the U.S. policy will force authorities abroad either to follow a similarly restrictive policy, or to acquiesce to increased volatility in exchange rates and domestic interest rates through the arbitrage relationship. Furthermore, if foreign monetary authorities pursue a less stringent anti-inflationary policy than the United States, they suffer the economic consequences of a depreciating currency in the foreign exchange markets.

Thus, policymakers abroad currently face two decisions: (1) they must either match the anti-inflation posture of U.S. policy or allow their currencies to depreciate against the dollar, and (2) they must choose the channel of volatility—either through exchange rates or interest rates. So far, most countries have decided not to match U.S. policy, and have allowed their currencies to depreciate. They have also chosen to minimize domestic interest-rate volatility at the expense of volatility in foreign exchange markets.

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## Quarterly Euromarket Report

($ billion, end of period)

| Total Market Size | IVQ/80 | IQ/81 | IIQ/81 | IIIQ/81 | 1979 | 1980 | 1981 |
|---|---|---|---|---|---|---|---|
| Gross Size (Claims) | 1,321.9 | 1,349.6 | 1,346.7 | 1,422.8 | 1,110.0 | 1,321.9 | 1,500.0 |
| Net Size (Claims) | 810.0 | 820.0 | 825.0 | 875.0 | 665.0 | 810.0 | 925.0 |
| **U.S. Banks and Their Foreign Branches** | | | | | | | |
| Total Liabilities to Foreigners | 287.5 | 290.3 | 286.8 | 292.8 | 269.7 | 287.5 | 315.0 |
| Liabilities to Private Nonbank Foreigners | 75.0 | 80.9 | 83.6 | 90.6 | 65.9 | 75.0 | 95.0 |
| Total Claims on Foreigners | 385.4 | 394.1 | 405.9 | 421.9 | 324.2 | 385.4 | 435.0 |
| Claims on Foreign Public Borrowers | 48.9 | 50.1 | 50.7 | 54.9 | 42.0 | 48.9 | 57.0 |
| Claims on Foreign Private Nonbank Borrowers | 139.9 | 142.8 | 145.3 | 148.6 | 117.8 | 139.9 | 155.0 |

*Note: Gross and net Eurocurrency market size definitions are those of the Bank for International Settlements (BIS). The difference between gross and net size is the interbank component. Net size includes transactions between banks in the Euromarket and: (a) official monetary authorities; (b) banks not participating in the Euromarket; and (c) nonbanks. U.S. bank and branch totals are net of transactions between parents and their foreign branches.*
*Source: Chase Manhattan Bank estimates based on BIS and national data sources.*